BELLSOUTH

Cynthia K. Cox
Executive Director-
Federal and State Relations

EX PARTE OR LATE FILED

Suite 900
1133-21st Street, N.W.
Washington, D.C. 20036-3351
202 463-4104
Fax: 202 463-4196

August 8, 1996

Ex Parte

Mr. William F. Caton
Acting Secretary
Room 222
1919 M Street, NW
Washington, DC 20554

Re: Ex Parte CC Docket No. 96-45, Federal-State Joint Board On Universal Service

Dear Mr. Caton:

Today, P. Martin, H. Brady, M. Talbot, R. Blau, W. Jordan, and the undersigned of BellSouth and W. Taylor, Vice President, NERA, engaged in a conference call to discuss BellSouth's position regarding the above-referenced proceeding with the following State Joint Board Staff Members: Paul Pederson, Missouri; Sam Loudenslager, Arkansas; Brian Roberts, California; and State Staff Members Barry Payne, Indiana and Suzanne McCormick, Arkansas. The attached documents represent the basis for the presentation and discussion and are consistent with BellSouth's filings in this proceeding. These documents are also being provided to the State Joint Board Staff members on the attached service list.

Pursuant to Sections 1.1206(a)(1) and 1.1206(a)(2) of the Commission's rules, two (2) copies of this notice and the attached documents are being filed with the Secretary of the FCC today.

Sincerely,

Cynthia K. Cox

Cynthia K. Cox

Attachments

cc: Paul Pederson, Missouri
Sam Loudenslager, Arkansas
Brian Roberts, California
Barry Payne, Indiana
Suzanne McCormick, Arkansas
State Joint Board Staff (see attached list)

Recommendations on Universal Service Funding

August 8, 1996

BellSouth Telecommunications, Inc.

Need to Make Implicit Support Explicit

- Telecommunications Act of 1996 requires that universal service support be explicit, sufficient, and sustainable
- Most support today is implicit, and will not be sustainable in a competitive environment
- Need to replace current federal universal service support mechanisms with explicit, sufficient and sustainable mechanism
- Telecommunications Act requires both state and federal mechanisms

Key Requirements of any New Funding Mechanism

- Should not shift burden for funding universal service between jurisdictions
- Should generally be revenue neutral upon implementation
- Purpose should be to replace current implicit support with explicit support

Universal Service Funding

- Three major components of Interstate fund
  - » Core Fund
    - – Social Pricing Fund
    - – Underdepreciated Plant (COLR)
  - » Education and Health Care
  - » Low Income

Core Universal Services

- Definition includes residential voice grade basic local exchange telephone service
  - » Single Party Service with Directory Listing
  - » Touch Tone
  - » Access to Emergency Services
  - » Access to Operator Services
  - » Access to Directory Services
- Total Support calculated on an unseparated basis
- Distinct split made between Interstate and Intrastate components
- Interstate support initially set equal to implicit Interstate CCL and RIC, DEM Weighting, Long-Term Support and explicit support from current USF Fund

Core Universal Services

- Replace current implicit support with SLC rebalancing and universal service fund
  - » One possibility would be to transition to maximum $6.00 SLC over four year period, as proposed by USTA
  - » Deaverage SLC and universal service support into wire center groupings where support per line varies based on cost characteristics

Core Universal Services

- All Interstate providers assessed on the basis of Interstate retail revenues less universal service revenues (SLC)
- Carriers must meet certain criteria to be designated as "eligible" for support
  - » offer universal service on a standalone basis throughout a defined serving area
  - » advertise the availability of service throughout serving area using general distribution media
  - » subject to service provisioning rules
  - » the carrier may use its own facilities or a combination of its own facilities and resale
- Support to be provided on a "per line served" basis to any eligible carrier

Core Universal Services

- BellSouth proposes that support always go to the facilities based carrier when resale of local exchange service is involved
- State Commissions to determine serving areas
  - » Costs vary between rural and urban areas
  - » Serving areas should reflect cost differences
  - » BellSouth recommends wire centers for determining universal service support if book costs are used

Core Universal Services

- Size of fund should be based on difference between actual embedded costs and revenues from universal service
- Portability of subsidy ensures efficient provision of service
- No proxy model can truly replicate actual costs

Size of Federal Universal Service Fund

- Core federal universal service fund would equal about $7.7 billion
- Core fund size could be decreased by up to $3 billion through SLC increases

Consider SLC Increases to Minimize Fund Size

- Interstate SLC has been $3.50 since 1989
- When SLC was implemented (late '80s), penetration levels increased
- Any increase in the SLC would be offset by a decrease in access charges
- IXCs should have obligation to flow through access charge reductions
- A modest gradual SLC increase would not affect affordability
- LifeLine assistance should be increased to match any increase in the SLC, thereby reducing overall expenditures for the low-income
- Rate rebalancing is part of the transition to a competitive environment

Advanced Services

- Basic telephone service line and modem allows access to the Internet and Advanced Services
- Deployment of Advanced services should not be mandated. The marketplace should be allowed to provide them in a timely and efficient manner
- Section 706 Notice of Inquiry
  - » FCC must initiate within 2 1/2 years from enactment of 1996 Act (by August 8, 1998)
  - » NOI must be completed within 6 months

Overview of Costing Approach:

- Fully distributed book costs should be used to calculate universal service support
- Since most support would be available to multiple carriers, competition would occur under a book cost approach, and prices would be competed downwards
- Actual book costs automatically consider all the variables that drive costs and do away with the need to resolve proxy cost arguments
- Actual book costs consider the actual network that is used to provide universal service rather than a theoretical network
- Use of proxy costs, a second best solution, could work if done in a revenue neutral manner

The Four Cost Proxy Models Under Consideration

- The original Benchmark Cost Model (BCM)
  - » Sponsored by USWest, Sprint, MCI and NYNEX
  - » MCI used a low annual cost factor, while the other three endorsed a higher ARMIS-based annual cost factor
- The Benchmark Cost Model 2 (BCM2)
  - » Sponsored by USWest and Sprint
  - » Significant changes made to original BCM
- The Cost Proxy Model (CPM)
  - » Developed by Dr. Rick Emmerson (INDETEC) for Pacific Bell
- The Hatfield Model - Version 2.2
  - » Sponsored by AT&T and MCI

The Original BCM is Seriously Flawed and Should Not Be Used

- Criticized by numerous parties including BellSouth
- It overestimates costs in rural areas and underestimates costs in urban areas
- It leaves out drop wire and terminal expense
- All expenses calculated based on a ratio to investment
- Census block groups sometimes assigned to wrong wire centers
- Grossly underestimates costs for many Eastern states

The Hatfield Model is Flawed and Should Not Be Used

- Endorsed by AT&T and MCI as a pricing tool
- The results have fluctuated greatly over time
- The model pulls in part from the flawed Benchmark Cost Model
- Minimal consideration of joint and common costs
- Uses prescribed depreciation lives rather than economic lives
- Uses unrealistic cost of money
- Uses overly high utilization factors
- Underestimates economic cost of service, especially in urban areas (e.g.- Fla. and Ga.)

The BCM 2 and the CPM appear to have some Potential for Use in Universal Service Support Calculations

- Both are based on sound engineering criteria
- Both consider some expenses on a per line basis and other expense on an investment basis
- Both use reasonable fill factors
- Both account for a reasonable share of joint and common costs
- Both allow some state specific inputs
- Both include drop wire and terminal investment

If a Proxy Approach is Adopted, then a Proxy Model that Combines the Best of the CPM and the BCM2 is Needed:

- The best of the CPM and the BCM2 could be combined. For example, one approach would be:
  - » use BCM2 as base
  - » incorporate grid cells rather than CBGs
  - » map grid cells to actual serving wire center rather than closest wire center
  - » use realistic distribution cable sizes
  - » use economic depreciation lives
  - » other items to be determined

Key Concluding Points

- The Federal universal service fund should replace the interstate CCL, TIC, and USF for non-rural companies
- Universal service support should be based on fully distributed book costs
- A system whereby universal service support is calculated based on proxy costs and affordability benchmarks is second best, but could be adopted if it is grounded in revenue neutrality upon implementation
- Over time, universal service support could be reduced through modest rate rebalancing and productivity improvements

Description of the Proxy Cost Approach

Step 1 - Determine Affordability Benchmark Rates

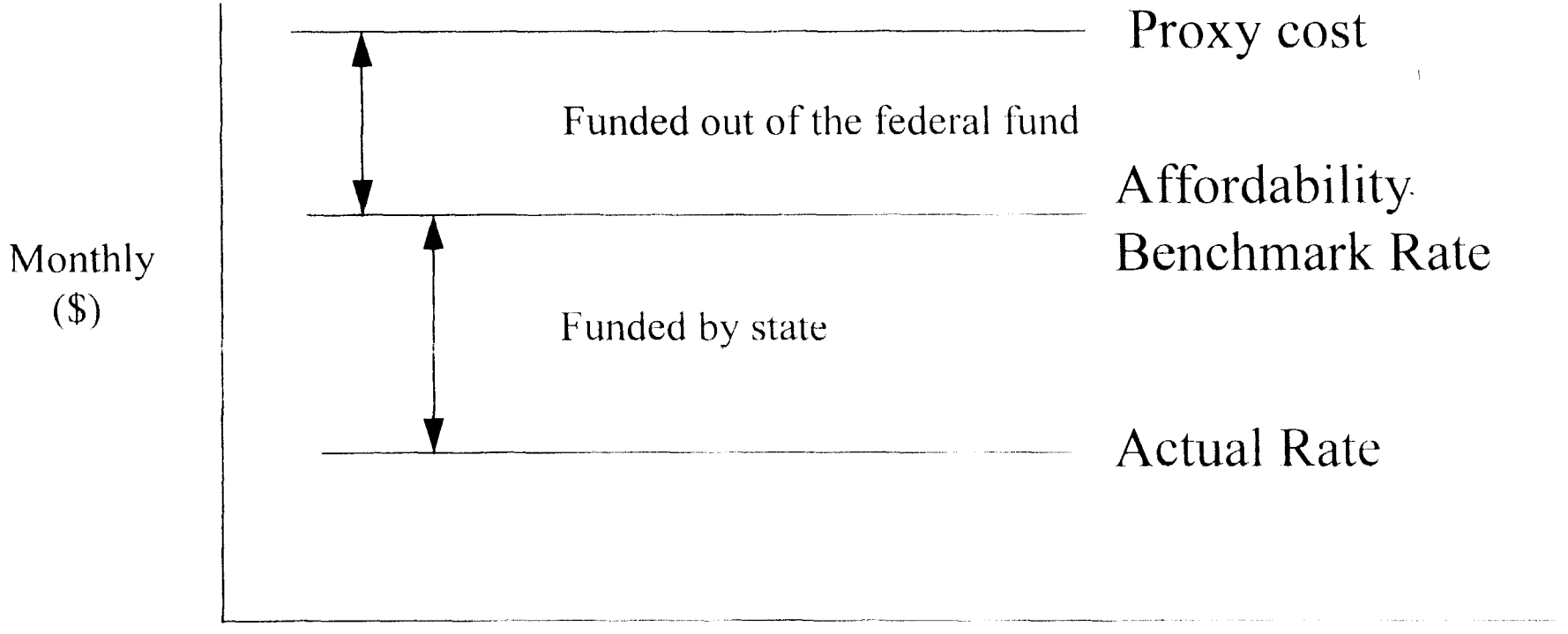
Step 2 - Calculate proxy costs for small areas

Step 3 - Calculate Federal support and state support per attached examples

Step 4 - Calculate total support for each local exchange company

Step 5 - Require rate reductions to offset net universal service support. Revenue neutrality upon implementation is essential.

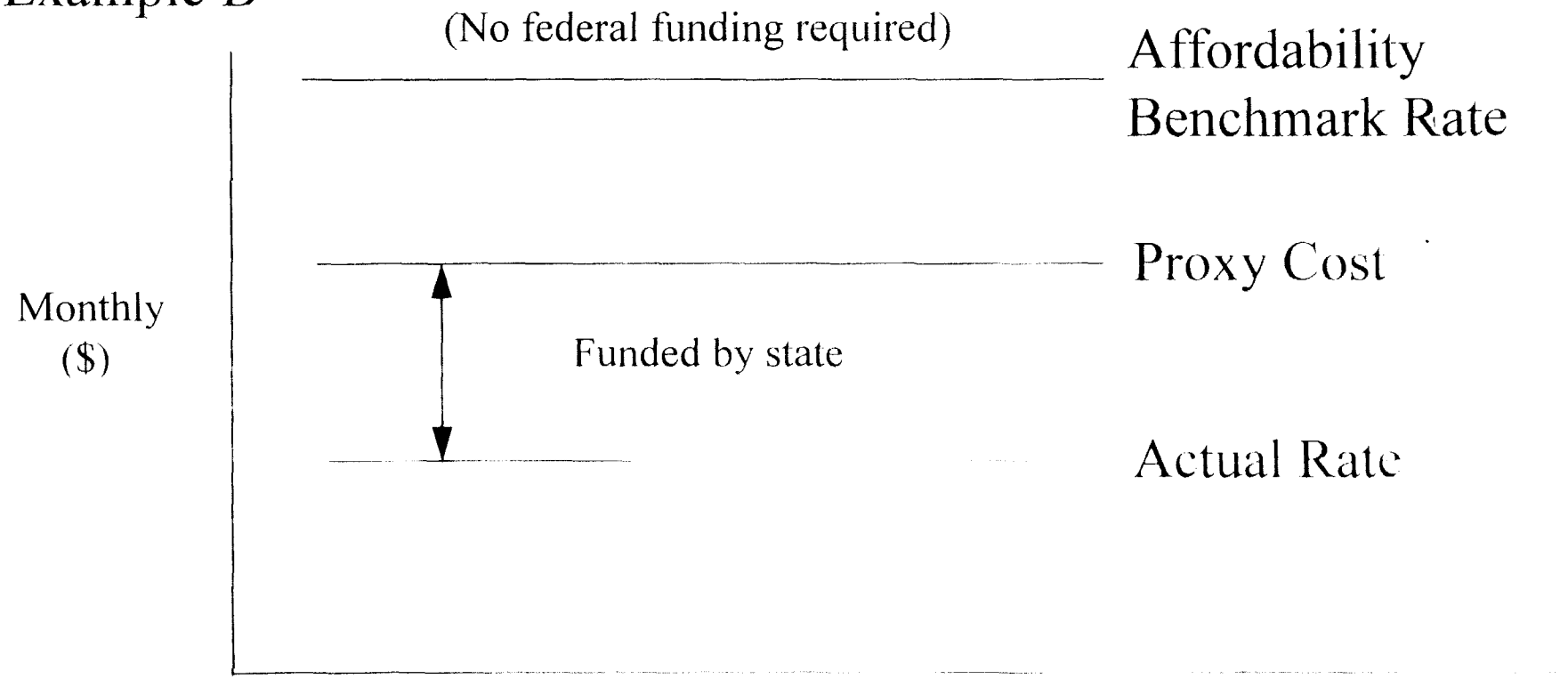
Example A



Example A:

In this scenario, funding is provided out of the federal universal service fund for the difference between the proxy cost and the affordability benchmark rate. The state is responsible for funding the difference between the affordability benchmark rate and the actual rate. It should accomplish this by establishing an intrastate universal service fund.

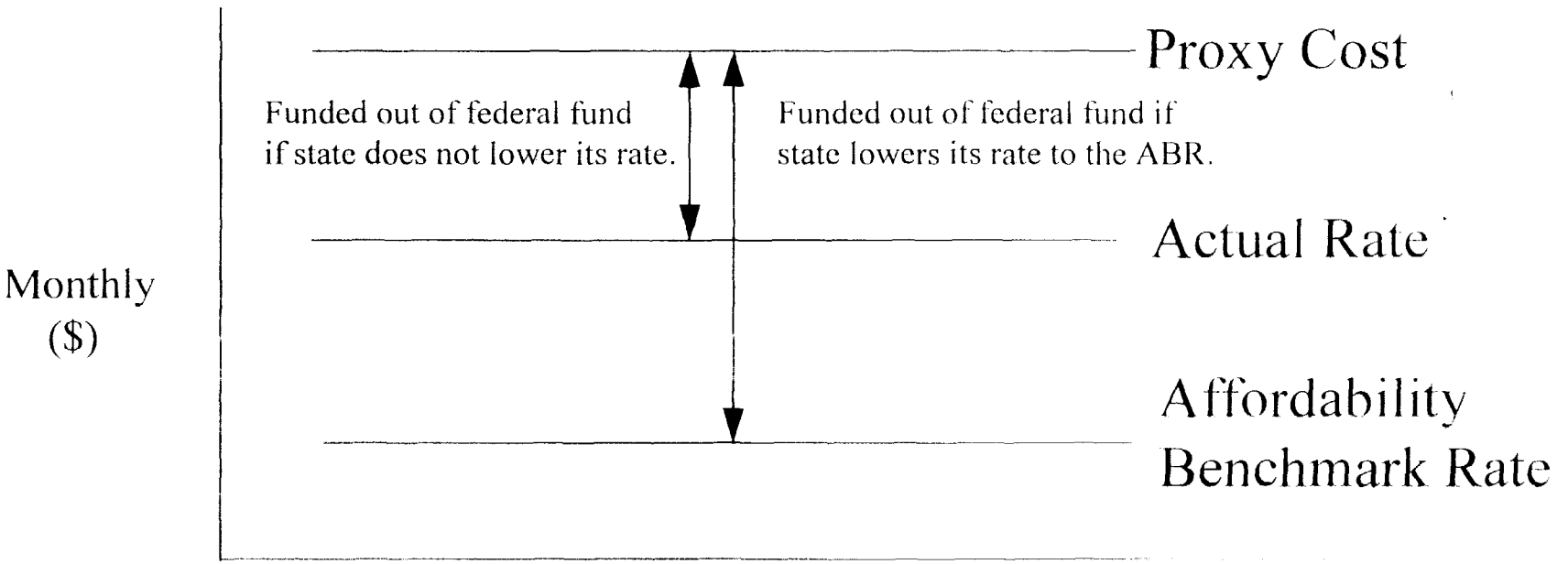
Example B



Example B:

In this scenario, the affordability benchmark rate is above the proxy cost. Therefore, no funding out of the federal support mechanism is required. The state is responsible for funding the difference between the cost generated by the proxy model and the actual rate. This should be accomplished via an intrastate universal service fund.

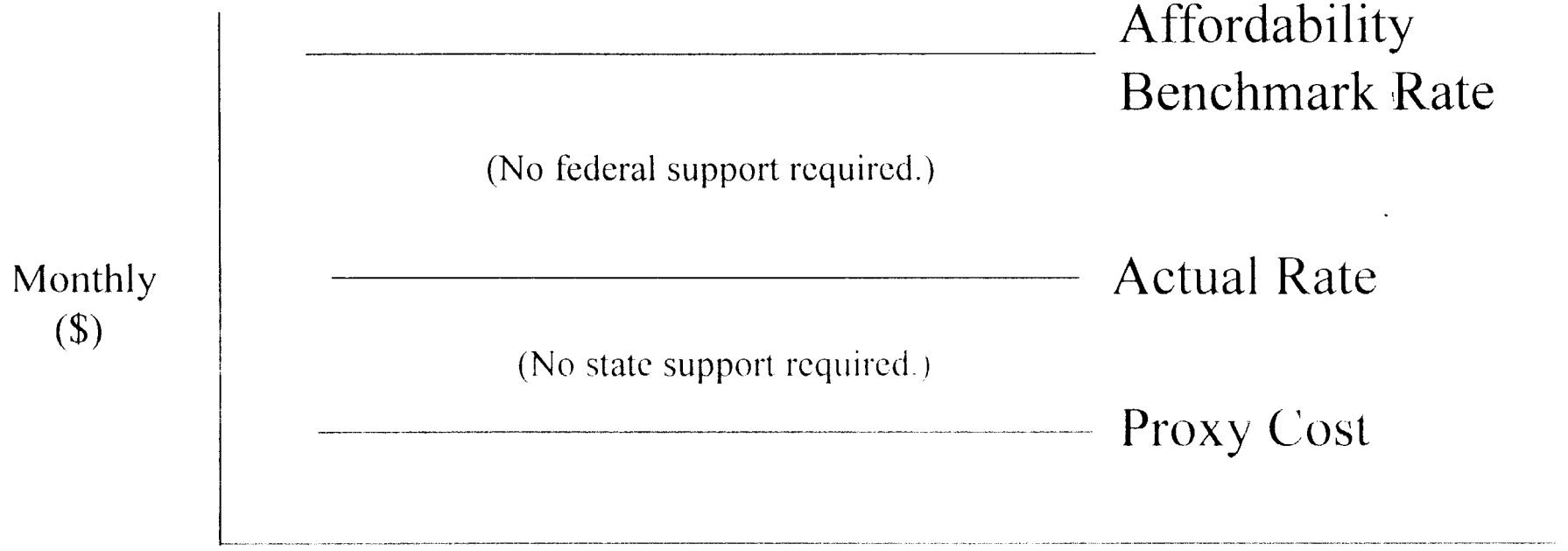
Example C



Example C:

In this scenario, which will probably be rare, the state has a rate that is actually above the affordability benchmark rate (ABR). The state should then have a choice. It can lower its rate to the affordability benchmark rate and receive federal support for the difference between the proxy cost and the affordability benchmark rate. Or, it can leave local rates where they are and receive federal support for the difference between the actual rate and the proxy cost. The state may choose this latter alternative if it believes local conditions justify a rate higher than is produced by the affordability benchmark rate calculations (which do not take into account local conditions). Under either approach, there would be no need for intrastate universal service support.

Example D



Example D:

In this scenario, the proxy cost is below both the affordability benchmark rate and the actual rate. As such, no universal service support is required out of the federal fund or the state fund.

If the proxy cost is truly indicative of actual costs, then competition will drive down the actual rate towards the proxy cost.

Note: The above outcome would also occur when the actual rate is higher than the affordability benchmark rate, and both are higher than the proxy cost.